

National Taxpayer Advocate

2007 Annual Report to Congress

2008 Annual Report to Congress

**NATIONAL
TAXPAYER
ADVOCATE**

**2008 ANNUAL REPORT
TO CONGRESS**

Executive Summary

Annual Report to Congress



Department of the Treasury
Internal Revenue Service

www.irs.gov

Publication 2104C (Rev. 12-2008)
Catalog Number 23655L

2008

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December 31, 2008

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The Most Serious Problems Encountered by Taxpayers

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(III) requires the National Taxpayer Advocate to describe at least 20 of the most serious problems encountered by taxpayers. This year's report begins by identifying the five most serious problems and then divides the remaining problems into four categories – taxpayer service issues, compliance issues, examination issues, and general tax administration issues. The report also contains a status update on the IRS's Private Debt Collection program. Each of the most serious problems includes the National Taxpayer Advocate's description of the problem, the IRS's response, and the National Taxpayer Advocate's final comments and recommendations (with the exception of the first problem, which does not contain an IRS response because it does not involve IRS action). This format provides a clear picture of which steps have been taken to address the most serious problems and which additional steps the National Taxpayer Advocate believes are required.

The issues described in the report are as follows:

- 1. The Complexity of the Tax Code.** The largest source of compliance burdens for taxpayers is the complexity of the tax code. IRS data show that taxpayers and businesses spend 7.6 billion hours a year complying with tax-filing requirements. To place this in context, it would require 3.8 million full-time employees to work 7.6 billion hours. In dollar terms, we estimate that taxpayers spend \$193 billion a year complying with income tax requirements, which amounts to 14 percent of aggregate income tax receipts. One count shows the number of words in the tax code has reached 3.7 million, and over the past eight years, changes to the tax code have been made at a rate of more than one a day – including more than 500 changes in 2008 alone. All of this complexity imposes additional monetary costs on taxpayers – about 60 percent of individual taxpayers pay practitioners to prepare their returns and an additional 22 percent purchase tax software to assist them. Perhaps most troubling, tax law complexity leads to perverse results. On the one hand, taxpayers who honestly seek to comply with the law often make inadvertent errors, causing them either to overpay their tax or to become subject to IRS enforcement action for mistaken underpayments of tax. On the other hand, sophisticated taxpayers often find loopholes that enable them to reduce or eliminate their tax liabilities.

The National Taxpayer Advocate recommends that Congress substantially simplify the tax code. To assist Congress in pursuing tax simplification, this report includes a series of recommendations, including recommendations to repeal the Alternative Minimum Tax, streamline education and retirement savings tax incentives, simplify the family status provisions of the Code, allow taxpayers to exclude modest amounts of canceled debts from income without having to make an affirmative claim, reduce tax sunset and phase-out provisions, and revise the overall penalty structure. (See next section summarizing Legislative Recommendations.) More broadly, the report recommends six principles on which fundamental tax reform should be based.

- 2. The IRS Needs to More Fully Consider the Impact of Collection Enforcement Actions on Taxpayers Experiencing Economic Difficulties.** When the IRS contemplates taking enforced collection action against a taxpayer, both the tax code and IRS procedures require that IRS personnel consider whether the collection action will impose an economic hardship on the taxpayer. When the economy struggles and more taxpayers become unable to pay their tax liabilities, the importance of considering the impact of collection actions on taxpayers and their families becomes critical. In addition, while levy and seizure authority are important collection tools that allow the IRS to address serious incidents of noncompliance, a review of IRS historical enforcement data suggests that expanded use – as opposed to judicious use – of these tools does not necessarily translate into more tax dollars collected. For example, while the number of levies issued by the IRS increased by an astonishing 1,608 percent from fiscal year (FY) 2000 to FY 2007 – from 220,000 levies to about 3.76 million – the increase in total collection yield during this period was slightly less than 45 percent. To the contrary, historical enforcement data indicate that collection alternatives may be more effective at collecting liabilities from taxpayers having trouble paying their tax debts. To more effectively deal with taxpayers in these difficult economic times, the National Taxpayer Advocate recommends that the IRS provide specific guidance requiring pre-decisional consideration of economic hardship in all Internal Revenue Manual sections related to collection enforcement and encourage greater use of collection payment alternatives such as offers in compromise and partial payment installment agreements where economic hardship is present.
- 3. Understanding and Reporting the Tax Consequences of Cancellation of Debt Income.** When a creditor writes off a debt, the tax code generally treats the amount of the canceled debt as taxable income to the debtor, but Congress has carved out a number of exceptions. The rules that determine whether cancellation of debt income is includible in gross income are complex, and taxpayers often do not receive reliable information about their tax reporting and payment obligations. For example, the Mortgage Forgiveness Debt Relief Act of 2007 carved out an exception for debts canceled in the course of a home foreclosure, but the exception only applies to the extent that the loan proceeds were used to acquire or improve a principal residence. It appears that most subprime borrowers use a portion of their loans for other purposes (*e.g.*, to pay off car loans, credit card balances, student loans, or medical bills), and the exception does not apply to the extent loan proceeds were used for these “non-qualified” purposes. Moreover, taxpayers do not automatically receive the benefit of any exception. If they do not file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, with their tax returns to claim an exclusion and adjust their tax attributes, the IRS will assume the cancellation of debt is taxable (based on its receipt of a Form 1099-C, *Cancellation of Debt*, filed by the creditor). Even where Form 982 is properly filed, taxpayers who exclude canceled debt from income under the “insolvency” exception may receive IRS notices requesting additional documentation if they do not also provide a statement of insolvency, a requirement that does not appear in any IRS forms or publications. The National Taxpayer Advocate recommends that the IRS take several steps to address this problem, including

developing an insolvency worksheet that taxpayers can file with their returns and creating a centralized unit dedicated to handling cancellation of debt issues.

4. **Employment Taxes.** The National Taxpayer Advocate is concerned that IRS employment tax policies may overreach and undermine some of the important protections enacted in the Taxpayer Bill of Rights and the IRS Restructuring and Reform Act of 1998. With an estimated \$58 billion in unpaid employment taxes, it is clear that the IRS faces a significant noncompliance problem. At the same time, the overall employment tax compliance rate is high – approximately 88 percent of all employment tax returns are filed and fully paid. While the need to collect unpaid payroll taxes is obvious, the IRS should follow a tailored approach to address the problem, including applying different treatments to taxpayers based on their levels of and reasons for noncompliance, encouraging prospective voluntary compliance by helping taxpayers who are attempting to follow complex rules and procedures, concentrating sufficient resources on early intervention techniques to prevent the accumulation of substantial employment tax liabilities, and building a local compliance presence that balances enforcement with outreach and education.
5. **IRS Process Improvements to Assist Victims of Identity Theft.** Identity theft occurs when one person unlawfully uses another person’s personal data to commit fraud or other crimes. In the past year, the IRS has improved its identity theft process in a number of ways, including establishing an Identity Protection Specialized Unit and a toll-free hotline for identity theft victims. These changes, if properly managed, should provide more assistance to victims of identity theft. The IRS recognizes identity theft as a serious problem and has agreed to address the concerns and recommendations that the National Taxpayer Advocate has previously raised. In light of the IRS’s agreement with our suggestions, the National Taxpayer Advocate makes no specific additional recommendations at this time. However, she will continue to urge the IRS to implement the following actions: provide global account review and account monitoring (if necessary) for all identity theft victims; allow employees the discretion to deviate from established guidelines in accepting evidence of identity theft; and allow employees more latitude in determining the rightful owner of a disputed Social Security number.

Taxpayer Service Issues

6. **Taxpayer Service: Bringing Service to the Taxpayer.** Since announcing its original plan in 2001 to establish 676 Taxpayer Assistance Center (TAC) sites, the IRS has established only 401 TACs and just 55 percent of them are open 36 to 40 hours per week. Further, 40 percent of taxpayers live more than a 30-minute drive from a TAC, and TACs are unable to handle many issues and questions. Similarly, the Small Business/Self-Employed Division since 2001 has sharply reduced its planned education and outreach program for small business taxpayers. In both instances, the IRS has sought to meet taxpayer needs by increasing Internet service. While that trend is generally positive, there remain significant numbers of taxpayers who do not have access to the Internet and there are certain categories of service that are more effectively handled through face-to-face interaction. The

National Taxpayer Advocate recommends that the IRS collaborate with TAS on all ongoing and new studies pertaining to taxpayer service, including the Taxpayer Assistance Blueprint for small business and self-employed taxpayers currently underway, and take steps to identify innovative approaches to delivering in-person assistance.

- 7. Navigating the IRS.** The IRS employs more than 100,000 workers in 12 major business units in over 800 offices within and outside the United States. Taxpayers, practitioners, and even IRS employees have difficulty finding the appropriate office or employee to help them resolve tax problems. The IRS does not publish a topical or personnel directory that would assist taxpayers in navigating the agency. By comparison, this information is provided clearly on the websites of taxing authorities in other countries and U.S. states. The National Taxpayer Advocate recommends that the IRS take steps to address this problem, including revising the Internal Revenue Manual to direct IRS employees to accommodate taxpayer requests to speak to a particular employee, adding departmental phone numbers to the topical index on IRS.gov, and considering the creation of a phone number staffed by operators who would obtain details about the taxpayer's question or problem and direct the taxpayer to the function that can help.
- 8. IRS Handling of ITIN Applications Significantly Delays Taxpayer Returns and Refunds.** Any individual who must file a tax return but is not eligible to obtain a Social Security number must apply to the IRS for an Individual Taxpayer Identification Number (ITIN). With limited exceptions, ITIN applications must be submitted with a tax return filed on paper. In 2005, the inability to receive an ITIN before preparing and filing a paper tax return caused processing delays that affected 280,000 refunds totaling over \$500 million. In addition, the IRS requirement for ITIN applicants to file paper returns is inconsistent with the congressional mandate for the IRS to achieve an 80 percent e-file rate. The IRS has provided inadequate assistance and information to applicants, as evidenced by the high number of incomplete and rejected applications, restricted telephone access to ITIN personnel, and failure to expand the Certified Acceptance Agent program. The National Taxpayer Advocate recommends several actions for streamlining the ITIN process, which include permitting individuals to submit an ITIN application prior to the filing season where the individuals can demonstrate an imminent need to file a return, allowing new ITIN applicants to file returns electronically, and promptly acknowledging all applicant requests for the return of original documents.
- 9. Access to the IRS by Individual Taxpayers Located Outside the United States.** Approximately five million American citizens living outside the country and over a half million troops deployed overseas need a way to contact the IRS when they have inquiries about their accounts or the tax laws. These taxpayers have limited options for obtaining information, filing returns, and replying to IRS notices and letters. There are only four IRS overseas customer service posts available to taxpayers with U.S. filing obligations, who are spread over 194 countries and more than 60 territories. Those outside the United States generally incur greater expenses, such as international telephone charges, transportation, and carrier mailing costs, when trying to communicate with the IRS. Although the IRS

has developed customer service initiatives as a part of its strategy for international tax administration, it does not provide enough resources to meet the needs and preferences of taxpayers based outside the country. The National Taxpayer Advocate's recommendations for improving customer service for overseas taxpayers include opening toll-free international telephone lines and providing overseas taxpayers with secure online access to their tax accounts.

Compliance Issues

- 10. Customer Service Within Compliance.** Simply stated, the IRS gets what it measures. The IRS largely rates operational performance by using *efficiency* measures (e.g., cycle time, case closures, and average call time) instead of *effectiveness* measures (e.g., did the IRS's actions achieve the desired voluntary compliance results?). The 2008-2009 IRS Strategic Initiative includes the goal to "Improve service to make voluntary compliance easier." Yet current measures do not promote customer service and may ultimately lead to noncompliant behavior by taxpayers, because IRS business strategies and measures do not adequately emphasize a balanced approach between taxpayer service and enforcement within the IRS's compliance organizations. The IRS has the opportunity to establish taxpayer-centric measures that encompass effectiveness as well as efficiency components to accomplish this strategic goal. The National Taxpayer Advocate recommends four actions to address this problem, including creating an IRS Cognitive Learning Lab and making it possible for taxpayers to work with one employee from start to finish on a case.
- 11. Local Compliance Initiatives Have Great Potential But Face Significant Challenges.** Research suggests that concentrated examinations targeted at a local business segment or industry have a greater "ripple effect" on voluntary compliance by other taxpayers than seemingly random examinations. Compliance initiative projects (CIPs) allow local IRS employees to generate this impact by focusing on specific local compliance problems using examinations or "alternative treatments," which may include outreach, education, form changes, regulatory changes, or even agreements with the states. The CIP process also enables employees from different IRS functions to work together, utilize local sources of information, and reach out to local organizations to address noncompliance at the local level. In addition, CIPs allow the IRS to learn about what works and what does not. The National Taxpayer Advocate is concerned that the IRS has neglected this important program. She recommends that the IRS take steps to revitalize it, such as developing better measures for local CIPs, allocating more resources to local CIPs, and making CIP reports more widely available to preserve the benefits of any lessons learned.
- 12. Customer Service Issues in the IRS's Automated Collection System (ACS).** ACS is a main component of the IRS's collection process, sending automated collection notices to millions of taxpayers and employing numerous telephone assistors to receive calls from these taxpayers. Although ACS generally receives relatively high customer satisfaction survey ratings and internal quality assessments, TAS has received numerous complaints from tax professionals and taxpayers that suggest the need for improvements. ACS customers have

raised concerns about extensive wait times, the inability to fax documents to employees, overly burdensome procedures, and general dissatisfaction with the ACS process. Neither ACS's customer satisfaction surveys nor its internal quality reviews measure these important aspects of taxpayer service. The National Taxpayer Advocate has identified several steps the IRS can take to improve processes that drive customer satisfaction, most importantly the need for the IRS to evaluate the entire customer experience with ACS instead of assessing only a "snapshot" in time.

- 13. The IRS Should Proactively Address Emerging Issues Such as Those Arising From "Virtual Worlds."** By one estimate, about \$1 billion in real dollars changed hands in computer-based environments called "virtual worlds" in 2005. Over 16 million people are estimated to have active subscriptions to these environments, many of which have their own virtual economies and currencies. However, IRS employees have been unable to respond to taxpayer inquiries about how to report transactions associated with them. Economic activities in virtual worlds may present an emerging area of tax noncompliance, in part because the IRS has not provided guidance about whether and how taxpayers should report such activities. To improve voluntary tax compliance, the National Taxpayer Advocate recommends that the IRS issue guidance addressing how taxpayers should report economic activities in virtual worlds.

Examination Issues

- 14. Suitability of the Examination Process.** Since 2000, the IRS has continuously increased the number of individual income tax return examinations it conducts. The number more than doubled from 617,765 in FY 2000 to 1,384,563 in FY 2007, with examinations completed by correspondence accounting for 83 percent of all individual taxpayer audits. Although taxpayers understandably do not like to be audited, the IRS should initially assume good faith on the part of taxpayers and avoid taking an unnecessarily adversarial approach. The Internal Revenue Manual and IRS publications provide opportunities for the IRS to meet taxpayer needs and preferences throughout the examination process, including allowing taxpayers to choose a method for conducting an examination (face-to-face versus correspondence), request a telephone discussion with the examiner, and even set up a payment agreement for any taxes owed. Because the IRS often fails to meet taxpayer needs and preferences due to limited resources or policy reasons, the resulting unsuitability of the examination process can lead to disparities in audit and customer satisfaction results, including tax assessments that sometimes reflect the taxpayer's inability to navigate the audit process rather than the amount truly owed. The National Taxpayer Advocate recommends five actions to help the IRS address problems with the suitability of the examination process, including directing its focus substantially toward meeting taxpayer needs and preferences and immediately eliminating the so-called "combination letter" from the process.
- 15. The IRS Correspondence Examination Program Promotes Premature Notices, Case Closures, and Assessments.** In FY 2007, the IRS conducted 83 percent of all individual

income tax examinations exclusively by mail in an effort to expand its audit coverage. The program as currently designed, however, is plagued by problems that increase taxpayer burden. These problems include a preoccupation with closing cases rather than working with taxpayers to resolve audit issues and an automated process that causes perpetual delays in responding to taxpayer correspondence. These issues lead to premature notices, premature case closures, and premature assessments, all of which drive taxpayers to TAS for help and generate needless re-work for IRS employees. The National Taxpayer Advocate urges the IRS to protect taxpayers by requiring managers and employees to adhere to the agency's longstanding audit quality standards in conducting correspondence examinations.

Tax Administration Issues

- 16. The Impact of IRS Centralization on Tax Administration.** Over the years, the IRS has centralized many of its major operations and programs. This centralization has significantly changed the organizational structure, management, work processes, and the quality of interaction between the IRS and taxpayers. When carried out correctly, centralization can significantly reduce redundancies and increase effectiveness. However, if the IRS fails to consider the impact of centralization on taxpayer service and compliance, it may harm taxpayers. The IRS needs to do a better job of measuring the downstream consequences to taxpayers, including the impact on taxpayer service and compliance, when evaluating the costs and benefits of centralization. The National Taxpayer Advocate recommends that the IRS establish a standard matrix that defines the project, provides background information, sets forth objectives, establishes tangible products, quantifies expected benefits, and identifies necessary resources. The IRS should then use this standard project matrix to evaluate programs and determine whether the anticipated benefits of centralization have been realized.
- 17. Incorrect Examination Referrals and Prioritization Decisions Cause Substantial Delays in Amended Return Processing for Individuals.** Every year, more than three million taxpayers file amended returns for various reasons, including the complexity of the tax code, changes in their circumstances, late-year tax legislation, and incomplete or inaccurate tax preparation software. Many of these taxpayers experience unnecessary burden and delays. A cooperative IRS-TAS study of TAS amended return cases found the average taxpayer waited 26 weeks for the amended return to be processed before contacting TAS for assistance. These delays stem from the IRS not meeting its own processing guidelines, unnecessary referrals for audits, and management decisions to de-emphasize processing so-called "duplicate filings," which occur when more than one Form 1040 is filed with the same name and Social Security number. The National Taxpayer Advocate recommends that the IRS allow individual taxpayers to file amended returns electronically to reduce errors and shorten processing times, eliminate unnecessary audit referrals, and create a special unit to resolve duplicate filing cases as a top priority.

- 18. Inadequate Files Management Burdens Taxpayers.** From FY 2005 through FY 2008, the IRS refunded over 40 percent (more than \$3.7 million) of the fees it collected for photocopies of taxpayers' documents because it could not locate the files the taxpayers needed. The IRS is required by law to efficiently maintain and manage agency records, including electronic and paper files, as evidence of IRS policies, decisions, and operations. Both taxpayers and IRS employees need prompt access to paper documents to resolve tax return issues or verify taxpayer information, yet the IRS has failed to follow procedures and implement safeguards for maintaining and managing paper files and records. This failure has contributed to complaints from taxpayers, practitioners, IRS employees, and other stakeholders who experienced substantial delays or received the wrong taxpayer's documents. Although control of the Files operation reverted back to the IRS in 2008 after being contracted out for the past two years, the transition has not resolved most of the associated problems. To further improve the Files operation, the National Taxpayer Advocate recommends the IRS take proactive steps to develop a service-wide recordkeeping and paper-file management strategy and database, take steps to convert paper returns to an electronic format, and revise relevant Internal Revenue Manual provisions to employ adequate quality control and specific timeliness measurements for expedited taxpayer files requests.
- 19. The IRS Miscalculates Interest and Penalties But Fails to Correct These Errors Due to Restrictive Abatement Policies.** A TAS study has found that the IRS is miscalculating the failure to pay penalty and could be negatively impacting about two million taxpayer accounts annually. Moreover, the IRS's manual calculations of interest yields an accuracy rate of only 67.7 percent, which means nearly one out of three restricted interest accounts are incorrectly computed. The IRS is aware of, but has failed to correct, certain systemic problems that cause penalty and interest miscalculations. These incorrect calculations lead numerous taxpayers to believe they have fully paid what the IRS says they owe, only to receive subsequent bills for accruals of interest, penalties, or both. The IRS bears the cost of these inaccurate calculations, not only through rework by employees but also by taxpayers' reduced confidence in the IRS. The National Taxpayer Advocate recommends that the IRS consider allocating adequate resources toward planning and programming to resolve common penalty and interest computation issues, revising pertinent Internal Revenue Manual sections so *all* taxpayers are entitled to accuracy reviews of interest and penalty calculations, and re-evaluating the overly complex restricted interest procedures to make certain that all taxpayers receive accurate interest charges.
- 20. Inefficiencies in the Administration of the Combined Annual Wage Reporting Program Impose Substantial Burden on Employers and Waste IRS Resources.** The Combined Annual Wage Reporting (CAWR) program is designed to ensure that employers accurately report annual wage data to the IRS and the Social Security Administration. If the IRS discovers a discrepancy in the wage and tax data reported by an employer, it issues a notice and requests that the employer provide information to resolve the discrepancy. However, the CAWR notices are not clearly written. As a result, employers are often unable to identify the cause of the discrepancy and respond timely, which in turn may

lead the IRS to improperly impose penalties on the employers. From FY 2003 to FY 2008, the IRS eventually abated 81 percent of the penalty dollars it previously assessed, causing substantial rework for the IRS and needlessly burdening employers. The National Taxpayer Advocate recommends that the IRS provide specific information about the wage reporting discrepancy on notices, include the phone number for a live assistor in the CAWR unit on notices, and continuously train its employees about when it is appropriate to assess CAWR penalties.

Status Update

- 21. The IRS's Private Debt Collection (PDC) Initiative Is Failing In Most Respects.** IRS data now shows that the IRS's Collection function outperforms private collection agencies (PCAs) in almost every way, collecting three times as much as the PCAs and resolving more cases earlier in the process. Overall, the PCAs have only collected about four percent of the outstanding tax balances assigned to them, bringing in less than \$56 million in commissionable payments on \$1.46 billion of tax debt. The National Taxpayer Advocate has addressed a number of the PDC initiative's deficiencies in prior Annual Reports to Congress and testimony. Many of these concerns remain while new ones have arisen. In addition, despite initial expectations that the IRS could learn about state-of-the-art collection practices in private industry through its work with PCAs, the IRS has now acknowledged that it has not been able to identify any "best practices" from the private debt collection industry. The National Taxpayer Advocate remains concerned that there is an inherently greater risk to taxpayer compliance, taxpayer rights, and taxpayer privacy when tax collection is outsourced to private, for-profit businesses. Given this risk and the PCAs' unambiguous underperformance as compared with the IRS's own Collection function, the National Taxpayer Advocate continues to believe that the PDC program should be terminated.

Legislative Recommendations

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(VIII) requires the National Taxpayer Advocate to propose legislative recommendations to resolve or mitigate problems encountered by taxpayers. This year's report makes the following 17 recommendations, most of which are designed to reduce taxpayer burden by simplifying the tax code:

- 1. Repeal the Alternative Minimum Tax (AMT) for Individuals.** Few people think of having children or living in a high-tax state as a tax-avoidance maneuver, but under the unique logic of the AMT, that is essentially how those actions are treated. The AMT effectively requires taxpayers to compute their taxes twice – once under the regular rules and again under the AMT rules – and then to pay the higher of the two amounts. The regular tax rules allow taxpayers to claim tax deductions for each dependent (recognizing the costs of maintaining a household and raising a family) and for taxes paid to state and local governments (reducing “double taxation” at the federal and state levels), but the AMT rules disallow those deductions. It is estimated that 77 percent of all additional income subject to tax under the AMT is attributable to the disallowance of deductions for dependents and state and local tax payments. The AMT computations are also extremely burdensome. The National Taxpayer Advocate recommends that Congress repeal the Alternative Minimum Tax for Individuals in the context of fundamental tax reform.
- 2. Simplify the Family Status Provisions.** Notwithstanding the improvements brought about by enactment of a Uniform Definition of a Child in 2004, the tax code's family status provisions continue to ensnare taxpayers and make tax administration difficult simply because of the number of such provisions and their structural interaction. These provisions include filing status, personal and dependency exemptions, the child tax credit, the earned income tax credit, the child and dependent care credit, and the separated spouse rule under IRC § 7703(b). Many of the eligibility requirements – such as support or maintenance costs of the home – are difficult for the IRS to verify without conducting audits into taxpayers' personal and private lives. The National Taxpayer Advocate recommends that, as part of a comprehensive reform of the tax code's tax treatment of families, Congress consolidate the numerous existing family status-related provisions into two categories: (1) a Family Credit and (2) a Worker Credit. The refundable Family Credit would reflect the costs of maintaining a household and raising a family, while the refundable Worker Credit would provide an incentive and subsidy for low income individuals to work.
- 3. Simplify and Streamline Education Savings Tax Incentives.** The tax code contains at least 11 separate incentives to encourage taxpayers to save for and spend on education. The eligibility requirements, definitions of common terms, income-level thresholds, phase-out ranges, and inflation adjustments vary from provision to provision. The point of a tax incentive, almost by definition, is to encourage certain types of economic behavior. But taxpayers will only respond to incentives if they know they exist and understand them. Few if any taxpayers are both aware of each of the education tax incentives and familiar

enough with the particulars to make wise choices. The National Taxpayer Advocate recommends that Congress consolidate existing incentives and harmonize definitions and other terms to the extent possible.

4. **Simplify and Streamline Retirement Savings Tax Incentives.** The tax code contains at least 16 separate incentives to encourage taxpayers to save for retirement. These incentives are subject to different sets of rules governing eligibility, contribution limits, taxation of contributions and distributions, withdrawals, availability of loans, and portability. Similar to education incentives, the large number of options and lack of common definitions and terms can preclude taxpayers from making wise choices or understanding how each incentive works. The National Taxpayer Advocate recommends that Congress consolidate existing retirement incentives, particularly where the differences in plan attributes are minor. For instance, Congress should consider establishing one retirement plan for individual taxpayers, one for plans offered by small businesses, and one suitable for large businesses (eliminating plans that are limited to governmental entities). At a minimum, Congress should establish uniform rules regarding hardship withdrawals, plan loans, and portability.
5. **Worker Classification.** The complexity of and ambiguities in the existing worker classification rules create uncertainty and lead to noncompliance. In general, businesses are only required to pay employment tax, withhold income tax, and provide benefits with respect to employees. As a consequence, businesses often classify workers as independent contractors to reduce their costs. Some employees seeking to avoid their tax obligations may also prefer to be classified as independent contractors if the employer does withhold taxes or report the payments to the IRS. Depending on the terms of the relationship between a business and a worker, however, many workers should be classified as independent contractors. The National Taxpayer Advocate recommends that Congress (1) replace § 530 of the Revenue Act of 1978 with a provision applicable to both employment and income taxes and require the Secretary to issue associated guidance, including guidance with specific industry focus; (2) direct the IRS to develop an electronic tool to determinate worker classifications that employers would be entitled to use and rely upon, absent misrepresentation; (3) allow both employers and employees to request classification determinations and seek recourse in the United States Tax Court; and (4) direct the IRS to conduct public outreach and education campaigns to increase awareness of the rules as well as the consequences associated with worker classification.
6. **Simplify the Tax Treatment of Cancellation of Debt Income.** Most financially distressed individuals who lose their homes to foreclosure or cannot pay off their car loans, credit card balances, student loans, or medical bills probably do not realize that their delinquency may increase their tax liabilities, but it often does. The tax code generally treats canceled debts as taxable income. Congress has carved out a number of exclusions, including a recently enacted exclusion to help homeowners whose mortgage debts are canceled when their houses are foreclosed upon and sold, but taxpayers do not receive the benefit of these exclusions automatically. However, the rules are complex, and a taxpayer must file Form

Legislative Recommendations

982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, to claim an exclusion. Very few taxpayers or preparers are familiar with this intricate form. The National Taxpayer Advocate is concerned that tens of thousands and possibly hundreds of thousands of taxpayers who qualify to exclude canceled debts from gross income may not be filing Form 982. Instead, some of these taxpayers unnecessarily include the amount of the canceled debt in gross income (based on their receipt of a Form 1099-C, *Cancellation of Debt*), and other taxpayers who fail to include it unnecessarily face IRS examinations and tax assessments. The National Taxpayer Advocate recommends that Congress enact one of several proposed alternatives to remove taxpayers with modest amounts of debt cancellation from the cancellation of debt income regime.

7. **Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets.** The Internal Revenue Code contains more than 100 provisions that are temporary and set to expire soon, up from about 21 in 1992. Tax benefits have increasingly been enacted for a limited number of years in order to reduce their cost for budget-scoring purposes. Tax sunsets make it difficult for both the government and taxpayers to plan ahead, especially when there is significant uncertainty about whether Congress will extend a provision that is set to expire. The complexity and uncertainty caused by sunsets makes it more difficult for taxpayers to estimate liabilities and pay the correct amount of estimated taxes, complicates tax administration for the IRS, reduces the effectiveness of tax incentives, and may even reduce tax compliance. The National Taxpayer Advocate recommends that Congress consider several options to reduce or eliminate the procedural incentives to enact temporary tax provisions.
8. **Eliminate (or Simplify) Phase-Outs.** More than half of all individual income tax returns filed each year are affected by the phase-out of certain tax benefits as a taxpayer's income increases. Like tax sunsets, phase-outs are largely used to reduce the cost of tax provisions for budget-scoring purposes. However, phase-outs are burdensome for taxpayers, reduce the effectiveness of tax incentives, and make it more difficult for taxpayers to estimate their tax liabilities and pay the correct amount of withholding or estimated taxes, possibly reducing tax compliance. Phase-outs also create marginal "rate bubbles" – income ranges within which an additional dollar of income earned by a relatively low income taxpayer is taxed at a higher rate than an additional dollar of income earned by a relatively high income taxpayer. Because Congress could achieve a similar distribution of the tax burden based on income level by adjusting marginal rates, phase-outs introduce unnecessary complexity to the Code. The National Taxpayer Advocate recommends repealing phase-outs or at least taking another look at phase-outs to ensure that they are really necessary to accomplish their intended objective.
9. **Reforming the Penalty Regime.** The number of civil tax penalties has increased from about 14 in 1954 to more than 130 today. The last comprehensive reform of the tax code's penalty provisions was enacted in 1989, after careful study by Congress, the IRS, and others. Since then, legislative and administrative changes to the penalty regime have proceeded piecemeal, but without the kind of careful analysis conducted in 1989. The

National Taxpayer Advocate's primary recommendation is that Congress direct the IRS to (1) collect and analyze more detailed penalty data on a regular basis and (2) conduct an empirical study to quantify the effect of each penalty on voluntary compliance. Congress should appropriate additional funds for this research, as necessary. In the meantime, based on penalty reform principles identified in 1989, the National Taxpayer Advocate recommends 11 common-sense reforms, which are described in *A Framework for Reforming the Penalty Regime* in volume 2 of this report.

- 10. Modify Internal Revenue Code § 6707A to Ameliorate Unconscionable Impact.** Section 6707A of the Code imposes a penalty of \$100,000 per individual per year and \$200,000 per entity per year for failure to make special disclosures of a "listed transaction." Enacted in 2004 to help combat tax shelters, this penalty is having unconscionable and possibly unconstitutional impact on taxpayers who have done nothing wrong. The penalty *must* be imposed where a taxpayer fails to make the special disclosures – even if the taxpayer had no knowledge that the transaction was listed or even questionable, even if the taxpayer derived no tax savings from the transaction, and even if the transaction is not "listed" until years after the taxpayer entered into it and filed a return on which the transaction was reflected. A taxpayer who does business through a wholly owned S corporation is subject to a penalty of \$300,000 (\$200,000 at the entity level and \$100,000 at the individual level) for each year in which the transaction is reflected on a return. The requirement that this penalty be imposed without regard to culpability may have the effect of bankrupting middle class families who had no intention of entering into a tax shelter. The National Taxpayer Advocate recommends that Congress quickly amend § 6707A so that the amount of the penalty bears a proportional relationship to the amount of any tax savings realized.
- 11. The Time Has Come to Regulate Federal Tax Return Preparers.** Tax return preparers are an essential component of taxpayer rights and tax compliance. Despite the vital role return preparers play in effective tax administration, anyone can prepare a tax return for a fee — with no training, no licensing, and no oversight required. Attorneys, certified public accountants, and enrolled agents are all licensed by state or federal authorities and are subject to censure, suspension, or disbarment from practice before the IRS in the event of wrongdoing. Yet there is virtually no federal oversight over "unenrolled" preparers, who constitute the majority of tax return preparers today. The National Taxpayer Advocate recommends that Congress enact a registration, examination, certification, and enforcement program for unenrolled tax return preparers. In addition, Congress should direct the Treasury Department and the IRS to conduct a public awareness campaign to inform the public about the registration requirements.
- 12. Refund Delivery Options.** Particularly in light of the current downturn in the economy, federal tax refunds are an important source of funds for many individual taxpayers. As a result, the Treasury Department and the IRS need to provide all taxpayers with the ability to receive refunds as quickly as possible and at minimal cost. The National Taxpayer Advocate recommends that Congress direct Treasury and the IRS to minimize refund turnaround times; implement a Revenue Protection Indicator; develop a program to

enable unbanked taxpayers to receive refunds on stored value cards, and conduct a public awareness campaign to disseminate accurate information about refund delivery options.

- 13. Crediting an Overpayment Against an Unassessed, Outstanding Tax Liability.** In August of 2007, the IRS issued Revenue Ruling 2007-51, permitting the IRS to (1) reduce refunds pursuant to IRC § 6402(a) to satisfy unassessed tax liabilities or (2) credit a decrease in tax resulting in a carryback adjustment against an unassessed liability. Permitting the IRS to reduce a refund to satisfy an unassessed liability inappropriately allows collection prior to assessment. The examples described in the revenue ruling were limited to corporations, and the Office of Chief Counsel has advised Congress that it is only applying the ruling to corporations. However, Revenue Ruling 2007-51 undermines taxpayers' right under IRC § 6212 to challenge a proposed deficiency before assessment and payment of the tax. Absent compelling public policy, taxpayers, particularly low income taxpayers who rely on refunds to help pay for basic living expenses, should be protected from this type of premature collection. If Congress shares the IRS's concern that large refunds or credits are being issued when corporations have significant unassessed liabilities, the National Taxpayer Advocate recommends that Congress carve out a specific exception in the Code for these circumstances.
- 14. Waiver of Levy Prohibition Under Internal Revenue Code § 6331(k).** IRC § 6331(k) generally provides that the IRS cannot levy on a taxpayer's assets while an offer in compromise (OIC) is pending or an installment agreement (IA) is pending or in effect. This prohibition does not apply, however, if the taxpayer files a written notice with the IRS waiving the levy restriction. The National Taxpayer Advocate has witnessed occasions when the IRS has attempted to require a waiver in exchange for agreeing to an IA. The IRS may make such a waiver a necessary condition to obtain an IA or OIC. To protect taxpayers from IRS overreaching, the National Taxpayer Advocate recommends that Congress amend IRC § 6331(k)(3)(A) to clarify that the IRS is prohibited from conditioning approval of an IA or OIC on the taxpayer's execution of a waiver of the levy prohibition.
- 15. Mailing Duplicate Notices to Credible Alternate Addresses.** IRS notices often trigger the legal rights and obligations of taxpayers to take critical actions, such as contest a liability, challenge a notice of deficiency, or contest a lien filing, and most require the taxpayer to take the action within a specified number of days. The IRS mails these notices to the taxpayer's last known address. However, with a population that is mobile and transitory, the last known address contained in the IRS's Master File may not reflect the taxpayer's current residence. As a result, taxpayers who are between return filing seasons and have not updated their addresses with the IRS or the U.S. Postal Service may not receive critical notices from the IRS. The National Taxpayer Advocate recommends that Congress direct the Secretary of the Treasury to develop procedures for checking third party databases for credible alternate addresses prior to sending notices that establish legal rights and obligations and, when there is a credible alternate address, require the IRS to mail the notice simultaneously to the last known address and to the credible alternate address.

- 16. Health Insurance Deductions for Self-Employed Individuals.** Many wage-earners participate in benefit plans that allow them to exclude the amount of their health insurance premiums from gross income, thereby avoiding Social Security and Medicare taxes. Unlike their wage-earning counterparts, self-employed individuals cannot deduct health insurance costs when determining net earnings for self-employment tax purposes. The National Taxpayer Advocate recommends that Congress repeal IRC § 162(l)(4) to place self-employed taxpayers on an equal footing with their wage-earning counterparts.
- 17. Mileage Deduction for Charitable Activities.** IRC § 162(a) generally allows a trade or business to take a deduction for trade or business expenses associated with operating a passenger automobile. The IRS adjusts the standard mileage rate for business expenses annually, accounting for inflation. Unlike the standard mileage deduction for business expenses, however, the deduction for charitable activities is specified in the tax code, which denies the IRS the discretion to adjust the amount from year to year. The National Taxpayer Advocate recommends that Congress amend IRC § 170(i) to allow the Secretary of the Treasury to determine the standard mileage rate for charitable activities.

The Most Litigated Tax Issues

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(X) requires the National Taxpayer Advocate to identify the ten tax issues most often litigated in the federal courts and to classify those issues by the category of taxpayer affected. The cases we reviewed were decided during the 12 months that began on June 1, 2007, and ended on May 31, 2008. In addition, the report contains a discussion of certain judicial decisions that did not involve one of the ten most frequently litigated issues but were significant because of their holdings.

- 1. Gross Income Under IRC § 61 and Related Sections.** When preparing tax returns, taxpayers must compute their gross income for the taxable year to determine the tax that must be paid. Disputes over whether certain payments must be included in gross income are among the Most Litigated Issues each year. Common issues in the 205 cases we identified during our review period included the taxation of damage awards and foreign earned income.
- 2. Appeals from Collection Due Process (CDP) Hearings Under IRC §§ 6320 and 6330.** CDP hearings provide taxpayers with an independent review by the Office of Appeals of the IRS's decision to file a lien or its proposal to undertake a levy action. Federal courts issued at least 179 opinions on this issue during our review period. Some critics have argued that the CDP proceedings delay the IRS collection process and allow taxpayers to raise frivolous arguments. However, the National Taxpayer Advocate remains convinced that the CDP process serves an important function by providing taxpayers with an important final opportunity to raise legitimate issues. We believe the opinions reviewed during the past year support this view. Many of the decisions provide useful guidance on substantive issues. Moreover, where taxpayers attempted to use the CDP process inappropriately, courts generally imposed sanctions or warned taxpayers about the possibility of sanctions being imposed in the future.
- 3. Summons Enforcement Under IRC §§ 7602, 7604, and 7609.** The IRS has the authority to summon the production of books, records, other data, or testimony from witnesses when investigating a civil or criminal tax liability and may serve a summons directly on the subject of the investigation or on a third party recordkeeper. A person who is subject to a summons may contest the legality of the summons if the government brings a proceeding to enforce the summons and may raise appropriate defenses at that time. Once a summons is served upon a third party recordkeeper, that person can challenge the legality of the summons. Generally, the burden on the IRS to establish the validity of the summons is minimal and the burden on the taxpayer to establish illegality is formidable. The taxpayer or recordkeeper prevailed in full in only three of the 146 cases we identified. The number of cases involving summons enforcement has more than tripled since 2005, when this issue first appeared among the ten most litigated issues.
- 4. Trade or Business Expenses Under IRC § 162 and Related Sections.** The deductibility of trade or business expenses is perennially among the ten most litigated tax issues in the

federal courts. We identified 116 cases that included a trade or business expense issue. The courts affirmed the IRS position in nearly three fourths of the cases, while taxpayers prevailed in full in only six cases. The remaining cases resulted in split decisions.

5. **Accuracy-Related Penalty Under IRC § 6662(b)(1) and (2).** IRC § 6662(b) authorize the IRS to impose a penalty if (1) a taxpayer's negligence or disregard of rules or regulations caused an underpayment of tax, or (2) an underpayment of tax exceeded a computational threshold called a "substantial understatement." IRC § 6662(b) also authorizes the IRS to impose three other accuracy-related penalties. However, taxpayers litigated these other penalties less frequently than the negligence and substantial understatement penalties, and our analysis does not address the three less frequent accuracy-related penalties. We identified 87 cases that involved accuracy-related penalties. Taxpayers prevailed partially or fully in 29 percent of the cases. The National Taxpayer Advocate recommends that the IRS review these cases and develop training for its employees to improve its ability to identify erroneously imposed penalties.
6. **Civil Damages for Certain Unauthorized Collection Actions Under IRC § 7433.** IRC § 7433 establishes jurisdiction for United States District Courts (and, in certain circumstances, bankruptcy courts) to hear cases for damages sustained in connection with the wrongful collection of any federal tax because an IRS employee negligently, recklessly, or intentionally disregarded certain provisions of the tax code, IRS regulations, or the Bankruptcy Code. We identified 78 opinions that involved a claim for damages for unauthorized collection action under IRC § 7433. The courts affirmed the IRS position in the vast majority of cases. Taxpayers prevailed in six cases, while three resulted in split decisions.
7. **Failure to File Penalty Under IRC § 6651(a)(1) and Estimated Tax Penalty Under IRC § 6654.** We identified 66 decisions issued by the federal courts regarding the addition to tax under IRC § 6651(a)(1) for failure to file a timely tax return or the addition to tax under IRC § 6654 for failure to pay estimated income tax. The failure to file penalty is mandatory unless the taxpayer can demonstrate that the failure to timely file a tax return is a result of reasonable cause and not willful neglect. The estimated tax penalty is mandatory unless the taxpayer can meet a statutory exception. Taxpayers in the cases analyzed were largely unsuccessful in their attempts to avoid these penalties. Taxpayers did not prevail in full in any of the 66 cases, although eight cases resulted in split decisions. Thirty-five cases involved imposition of the estimated tax penalty in conjunction with the failure to file penalty, while only three cases involved the estimated tax penalty without simultaneous imposition of the failure to file penalty.
8. **Relief from Joint and Several Liability Under IRC § 6015.** Spouses filing joint tax returns are jointly and severally liable for any deficiency or balance due, enabling the IRS to collect the entire amount due from either taxpayer. However, IRC § 6015 provides three avenues for relief from joint and several liability. We identified 50 federal court opinions involving relief under IRC § 6015, where procedural issues and the taxpayer's knowledge were the most common subjects of litigation. Jurisdictional issues were less frequently litigated

The Most Litigated Tax Issues

than in the past, perhaps due to the passage of the Tax Relief and Health Care Act of 2006, which gave the Tax Court jurisdiction to review IRC § 6015(f) determinations where no deficiency has been asserted. However, district courts continue to take a restrictive view of the availability of the IRC § 6015 defense in district court proceedings. In her 2007 Annual Report to Congress, the National Taxpayer Advocate proposed that Congress amend IRC § 6015 to, among other things, clarify that taxpayers may raise relief from joint and several liability as an affirmative defense in district court proceedings.

9. **Frivolous Issues Penalty Under IRC § 6673 and Related Appellate-Level Sanctions.** The federal courts issued decisions in at least 49 cases involving the frivolous issues penalty under IRC § 6673 or related appellate-level sanctions. These penalties are imposed against taxpayers for maintaining a case primarily for delay, raising frivolous arguments, or unreasonably failing to pursue administrative remedies. The U.S. Tax Court decided 38 cases in which the penalty under IRC § 6673 was at issue. In 26 cases, it imposed the penalty. In 12 cases, it declined to impose the penalty but warned taxpayers they could face sanctions in the future for similar conduct. Taxpayers appealed the penalty in seven cases, but the U.S. Courts of Appeals sustained the penalty in each case. Federal appellate courts imposed additional sanctions in a small number of cases as well.
10. **Family Status Issues Under IRC §§ 2, 24, 32, and 151.** The 34 family status cases reviewed for this year's report involved disputes over the head of household filing status, child tax credit, earned income tax credit, and dependency exemption. The number of decisions on these issues has declined over the past two years, possibly due to the enactment of the Uniform Definition of a Child (UDOC). The UDOC appears to have made the analysis easier for the courts by generally establishing one definition of a "qualifying child." The UDOC also reduces the burden on taxpayers because it only requires them to establish the existence of a qualifying child under one standard, rather than several under prior law. We will monitor whether the number of family status cases continues to decline, as such a trend would suggest that the impact of the UDOC has been positive and that more simplification in this area could benefit taxpayers.

Volume Two: Research and Related Studies

Volume Two of the report contains in-depth studies that TAS has conducted or commissioned on important tax administration issues. This year's report contains a detailed assessment of the tax code's penalty regime and two research studies.

- 1. A Framework for Reforming the Penalty Regime.** The number of civil tax penalties has increased from about 14 in 1954 to more than 130 today. The last comprehensive reform of the tax code's penalty provisions was enacted in 1989, after careful study by Congress, the IRS, and others. The 1989 analysis concluded that penalties should be designed to enhance voluntary tax compliance. To achieve that objective, penalties need to be fair, effective, comprehensible, and easy to administer. As a consequence of "penalty creep," current law penalties sometimes deviate from these core principles. In addition, the IRS collects a limited amount of data on current law penalties and does not regularly study them. Our analysis builds on the 1989 analysis and uses the limited data the IRS collects to establish a framework for evaluating potential penalty reforms. It also elaborates on the National Taxpayer Advocate's legislative recommendations, which are briefly described in Volume 1 of this report (Legislative Recommendation: *Reforming the Penalty Regime*).
- 2. Building a Better Filter: Protecting Lower Income Social Security Recipients from the Federal Payment Levy Program.** The Federal Payment Levy Program (FPLP) enables the IRS to continuously levy up to 15 percent of certain federal payments to delinquent taxpayers. In 2008, more than 83 percent of the estimated two million FPLP payments the IRS received came from Social Security benefits. Until 2005, the IRS used a filter to protect low income taxpayers from FPLP levies on Social Security benefits. However, the IRS then removed the filter in response to questions about its effectiveness, and TAS FPLP cases have sharply increased since. This report documents TAS Research's design, development, and preliminary testing of an improved filtering or screening model designed to predict whether the FPLP levy will cause a taxpayer economic hardship. The new TAS model uses information from tax returns and payor documents to estimate a taxpayer's income, and uses other tax return data to estimate expenses routinely allowed by the IRS, when determining a taxpayer's ability to pay. The model then compares these two amounts to determine whether the taxpayer can afford to pay the FPLP levy on Social Security benefits. Extensive testing has found that, overall, the TAS model demonstrates sufficient reliability to be considered for use by the IRS to protect low income taxpayers from being harmed by the FPLP.
- 3. The Need to Increase Preparer Responsibility, Visibility, and Competence (a report prepared by Professor Leslie Book).** This report discusses a number of actions Congress and the IRS can take to improve the posture of paid tax return preparers with respect to fostering tax compliance in unambiguous areas like claiming the Earned Income Tax Credit and reporting sole proprietor income. Key objectives are to increase the visibility of preparer and taxpayer conduct and to emphasize the responsibility and accountability

of preparers to the tax system as well as to their clients. Because more than 60 percent of individual income tax returns are prepared by preparers, the IRS must more actively strive to understand the preparer community as part of any meaningful strategy to reduce the tax gap. In particular, the IRS must improve its ability to identify preparers, communicate with preparers, and educate preparers and taxpayers as part of a broad-based effort to achieve acceptable compliance levels. The report offers several steps, including reforming due diligence rules, requiring the use of a common preparer identification number, and registering and testing preparers to ensure a minimum competence level. The IRS must have the tools to remind potential bad actors that sanctions are always a possibility for egregious misconduct. However, the old audit-first approach cannot work, given agency resource constraints and the backlash that would likely accompany a meaningful increase in IRS audits of preparers and small business taxpayers.

Research and Related Studies

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